United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

75-6131

United States Court of Appeals

FOR THE SECOND CIRCUIT

B
P/S

NO. 75-6131

THE AETNA CASUALTY AND SURETY COMPANY,
Plaintiff-Appellant

vs.

UNITED STATES OF AMERICA,
Defendant-Appellee

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF CONNECTICUT

REPLY BRIEF OF THE PLAINTIFF-APPELLANT

UNITED STATES COURT OF APPEALS
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I

SECTION 381(b)(3) DOES NOT DISALLOW THE LOSS CARRYBACKS.

The single issue presented by this appeal is whether net operating losses sustained by the plaintiff, The Aetna Casualty and Surety Company ("New Aetna"), in 1964 and 1965 can be carried back against the positive taxable income generated by the same company, but by a different legal entity, for the year 1963. Prior to December 30, 1964, the shares of The Aetna Casualty and Surety Company ("Old Aetna") were owned approximately 62% by Aetna Life Insurance Company ("Aetna Life") and 38% by some 4,000 public stockholders. With a view to acquiring such minority shares, Aetna Life organized a wholly-owned shell corporation, New Aetna, whose sole asset was an appropriate number of Aetna Life's common shares. Old Aetna was then merged into the shell, the minority stockholders receiving shares of Aetna Life in exchange for their shares of Old Aetna. The effect of the merger was an exchange solely of Aetna Life stock for that of Old Aetna, raising Aetna Life's stock interest to 100%.

All the assets and liabilities of Old Aetna, together with its personnel, were conveyed to the shell in the merger. Apart from the shares of Aetna Life that were used to carry out the exchange, no new or additional assets were transferred to New Aetna, no cash or other property was withdrawn, and no change occurred in the operation of the business.

It is conceded by the defendant that if the plaintiff's business had continued in the hands of the old entity, then, despite the acquisition of the minority-owned shares by Aetna Life, the net operating losses sustained by the plaintiff in 1964 and 1965 would have been fully available as carrybacks under the general authority of Section 172 of

the Internal Revenue Code of 1954, as amended ("Code"). (All Section references herein are to such Code unless otherwise indicated.) The defendant contends, however, that by virtue of Section 381(b)(3), which precludes carry-backs except to the income of the acquiring corporation in so-called A, C, and D reorganizations, the plaintiff's operating losses may be carried back only against the pre-merger income of the new entity, but not against that of the old. Since the new entity was a mere shell with no prior operating history of its own, the effect of the defendant's view, if upheld, would be to eliminate the plaintiff's carry-back privilege for the years in question.

In urging its position upon the Court, the defendant has offered a perspective on Code policy in this area that is confused and incomplete. Based on that perspective, at least in part, it asks this Court to affirm the District Court's denial of the plaintiff's net operating loss carrybacks, although every familiar and customary consideration of tax equity points to their allowance.

Taken as a whole, the objective of Congress in enacting Section 381 was to establish liberal rules for the transferability of net operating losses in corporate reorganizations. Under the 1939 Code, the courts initially followed a simplistic entity concept: only the particular legal entity that had sustained a net operating loss was entitled to the benefit of a carryover. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934). This limitation was eroded by subsequent decisions — *see Helvering v. Metropolitan Edison Co.*, 306 U.S. 522 (1939), *Newmarket Manufacturing Co. v. United States*, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957), *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957) — but as late as 1954 the entity limitation was still thought to have an erratic and unpredictable vitality. In 1954, largely following the recommendations of the American Law Institute,[1] Congress swept away exist-

[1]American Law Institute, Federal Income Tax Statute, Vol. 2 at 330 (February 1954 Draft).

ing distinctions, generally rejected the formalism of the prior law, and adopted new rules that expressly authorize the transfer of loss carryovers to successor corporations.

Broadly speaking, as respects *carryovers,* Section 381 (a) permits the pre-acquisition losses of a transferor corporation to be offset against the post-acquisition income of a transferee corporation where a transfer of assets from the former to the latter qualifies as tax-free under Sections 368(a)(1)(A), (C), (D) with limitations, or (F). Survival of the transferor's net operating loss deduction is thus assured even though the loss corporation disappears as a consequence of the asset transfer, and even though the former shareholders of the loss corporation emerge with only a small fraction of the outstanding stock of the acquiring corporation. Nor is the deduction of the transferor's prior losses limited to the post-acquisition income generated by the same business that produced the loss (a restriction imposed by the *Libson Shops* decision for 1939 Code cases). Rather, the transferor's losses may be offset against the transferee's income even though the transferor's business continues to produce losses and the positive income of the merged entity is attributable solely to the business of the acquiring corporation. Rev. Rul. 58-603, 1958-2 Cum. Bull. 147. In effect, therefore, as respects the survival of net operating losses following a corporate fusion, previous limitations relating to continuing entity, share ownership, and business identity have all been removed.

However, Section 381 of the present Code contains two limitations, the first relating to corporate *divisions* qualifying under Section 368(a)(1)(D), the second to certain net operating loss *carrybacks.* These limitations are plainly at odds with the liberalizing objective described in the preceding paragraph. Yet each was adopted — as it were, reluctantly — because Congress perceived, or assumed, that each situation presented technical and administrative difficulties that would be insurmountable, or at least very troublesome, if an effort were made to bring them within the

general rule. It is important, in the plaintiff's view, that this latter element of legislative background be appreciated, because it demonstrates conclusively that the reorganization in question here is not of the class that Section 381(b)(3) was intended to restrict.

In a so-called corporate division, X Corporation, owning two separate operating divisions, transfers one operating division to a newly formed subsidiary corporation in exchange for the latter's stock, which is distributed to X's shareholders. Assuming that X sustained operating losses prior to the transfer, the question that would arise after such transfer would be how the company's loss carryover should be apportioned between the future income of X, which still owns one of the two divisions, and the future income of the new subsidiary. No such problem arises in an ordinary corporate merger, of course, because after the merger there is a single income stream against which the prior losses of either company can be deducted.

Congress resolved this problem in the case of corporate divisions by simply excluding such transactions from the benefits of Section 381(a)(2)[2] — that is, by refusing to authorize *any* apportionment procedure whatever. In effect, X's prior losses can be used only to offset the future income of X itself, and cannot be offset against the income of the subsidiary. This is true even though there is no change in the company's underlying stock ownership as a result of the division, and even though it may have been the subsidiary's business that generated the prior losses of the enterprise. While this outcome seems somewhat harsh, its severity merely serves to underline the fact that Congress was unwilling — either through statutory rule or through delegation of responsibility to the Treasury — to encumber the administration of the net operating loss pro-

[2] Section 381(a)(2) covers only those D reorganizations that entail a transfer of *all* the assets of the original company to a controlled successor, and thus meet the conditions of Section 354(b)(1)(A) and (B). Divisive D reorganizations — those that meet the requirements of Section 355 — are specifically excluded.

visions by adding complex requirements for income-apportionment and divisional accounting. Despite the equitable appeal of averging loss years and profit years where all economic interests remain intact (a far less debatable case than a merger between two previously unrelated taxpayers), Congress viewed the administrative burden of loss-and-income-apportionment as outweighing any other consideration in the divisive reorganization situation.

The same concern for administrative feasibility explains the "operating rules" of Section 381(b), including, of course, the limitation on carrybacks contained in paragraph (3) of that subsection. Consistent with the approach it took with respect to divisions, Congress again concluded that where an apportionment of the net operating loss deduction between two income streams would be necessary, it was preferable to avoid the resulting technical problems by confining the carryback to only one of the two potential users. Thus, where X Corporation merges into Y Corporation, both companies having separate tax histories prior to the merger, the carryback of post-merger losses is restricted by Section 381(b)(3) to the prior income of Y alone. This restriction applies even if the post-merger losses are traceable to the business formerly conducted by X. Moreover, contrary to the defendant's implication (Brief for the Appellee at 63), the carryback is allowable against Y's prior income even where Y is so much the smaller of the two entities that the refund of taxes previously paid by Y largely accrues to the benefit of X's former shareholders.

Avoiding the need for burdensome apportionment rules, then, is a legislative policy that is reflected consistently throughout Section 381. Thus, if X Corporation merges into Y Corporation, any pre-merger losses of X may be carried forward against the post-merger income of Y. Here there is a *single* positive income stream. Despite the possibility that the pre-merger losses and the post-merger profits may derive from different businesses, Congress declined

to complicate the averaging procedure with rules of allocation, and chose instead to permit X's losses to be deducted from Y's income. *Cf.* Rev. Rul. 59-395, 1959-2 Cum. Bull. 475. The same decision was made where there are *two* positive corporate income streams that might be offset by a net operating loss deduction — whether as a carryover in the case of a corporate division, or as a carryback following the merger of two operating companies. In these situations, Congress chose to avoid the need for apportionment by confining the deduction to the income stream generated by *one* of the two entities — the original company in the case of divisions, the surviving entity in the case of carrybacks.

Apart from establishing rules that would be "definite and rational" the defendant has been unable to suggest any other substantive policy which Congress might have intended to implement through Section 381(b)(3), and indeed the defendant concedes "that Congress was mindful of accounting problems" when it adopted the latter subsection. In fact, the *only* purpose was procedural simplification and administrative feasibility.

The plaintiff does not suggest that administrative simplicity is unimportant or that it should be ignored. What it does contend is that where, as here, the practical difficulties the statute seeks to avoid are wholly absent, a literal and mechanical application of the Code restriction frustrates the policy the legislature sought to implement. Since New Aetna was a shell corporation with no prior tax history of its own, there is obviously only one income stream that could be offset, and hence no apportionment problem arises. Imposition of the restriction contained in Section 381(b)(3) would be entirely pointless. Congress did not intend that it should be imposed. Since a sensible construction of the statute will avoid an unintended hardship, that construction should be embraced.

It is established beyond question that when the purpose of provisions of the Code is evident, those provisions, and

in particular the complex reorganization provisions, are to be applied in the light of their purpose rather than through a literal application of the statutory language. Inter-period averaging of profit and loss, now provided for in Section 172, has been a major equitable ingredient of the tax law virtually from its inception. To permit its purpose to be thwarted through an unintended and unnecessary application of Section 381(b)(3) is plainly undesirable. As it has elsewhere, this Court should recognize that the term "corporation" has a functional, and not just a formal, significance in Section 381(b)(3), and that in that context the term refers to more than a mere chartered entity having jural status under state law. Given the aim of the subsection, the Court can and should reverse the decision below by finding either that Section 381(b)(3) is inapplicable in the case of one-corporation reorganizations or that, except in a consolidation of two or more operating companies, the reference to an acquiring "corporation" in Section 381(b)(3) is to an existing entity with a separate period of status as a taxpayer or with operating assets of its own.

The defendant urges the Court to adopt a mechanical interpretation of Section 381(b)(3) and thereby to avoid "*ad hoc* determinations of the statute's applicability." It is notable, however, that the defendant offers no specific description of any situation that would require such "*ad hoc* determinations" if the plaintiff's position was adopted. No parade of horribles is presented in the defendant's brief, no ticklish line-drawing problems are referred to, no "thicket" of interpretative issues of the sort abjured by the Court in *Braunstein v. Commissioner*, 374 U.S. 65, 72-73 (1963), can be discovered. The reason is that none exists. The construction sought by the plaintiff would create no new opportunities for litigation; the task of statutory interpretation would remain a simple one. Consistent with its purpose, Section 381(b)(3) would apply where two operating companies with separate tax histories were joined;

but it would not apply where a single, ongoing concern was reorganized.

Adoption of the plaintiff's position would thus carry out the demonstrable intent of Congress. That intent, as the Treasury has said, is to distinguish for the purposes of Section 381(b)(3) between "amalgamating reorganizations and the reorganization of a single business." Rev. Rul. 69-185, 1969-1 Cum. Bull. 108, 109.

II

THE REORGANIZATION QUALIFIES EQUALLY AS A B AND AS A C REORGANIZATION.

Without any statutory support, the defendant has assumed that a B reorganization *requires* a voluntary exchange. Having assured itself that this is a prerequisite to a B reorganization, the defendant then asserts that the reorganization involved in this case does not meet this condition. However, the question before the Court is *whether* the definition of a B reorganization is as narrow as the defendant claims.

The reorganization in this case met all of the conditions of Section 368(a)(1)(B). There was (i) an acquisition by Aetna Life, (ii) solely for its voting stock, (iii) of stock of Old Aetna constituting "control" of the latter. All the relevant and operative conditions of Section 368(a)(1)(B) were thus met. The defendant emphasizes the "force-out" effect of a merger (Brief for the Appellee at 53), as compared with the voluntary character of an exchange offer. However, not only is "voluntariness" *not* a condition of Section 368(a)(1)(B), but the Treasury itself has ruled that mergers that, in effect, force an exchange upon the shareholders of the acquired corporation may constitute B reorganizations. Rev. Rul. 67-448, 1967-2 Cum. Bull. 144.

The defendant seeks to distinguish B reorganizations from C reorganizations on the sole ground that in the latter the old corporation transfers its assets to another entity, while in the former it does not (Brief for the Appellee at 60). However, this distinction is nowhere found in the statute and provides no basis for disallowing the plaintiff's net operating loss carrybacks under Section 381(b)(3). Characteristic of a B reorganization is that the operating business of the acquired corporation remains intact — being neither integrated with nor joined to a previously separate set of operating assets. Thus, where one corporation acquires the stock of another *solely* in exchange for the former's voting stock, and where the acquisition is accomplished by merging the acquired company into an empty shell, the transaction meets the conditions of both Sections 368(a)(1)(B) and (C) and qualifies as tax-free under either statutory definition.

The defendant unwarrantedly criticizes the decision in *Casco Products Corp.*, 49 T.C. 32 (1967), *appeal dismissed* (2d Cir. 1968). The Tax Court in that case held that Section 381(b)(3) did not apply where a parent corporation merged a partly-owned operating subsidiary into a wholly-owned shell corporation as a means of eliminating the minority interest in the subsidiary. Speaking through Judge Tannenwald, the Tax Court found that the merger was merely a "legal technique" for acquiring the minority shares, and not an A or a C reorganization. As a result, the post-merger operating losses incurred by the "new" entity were permitted to be carried back against the premerger income of the "old."

In *Casco Products* the parent corporation acquired the minority stock of its subsidiary by paying cash to the minority stockholders. The transaction was therefore held to be a redemption rather than a reorganization. In the present case, the parent corporation, Aetna Life, acquired the minority stock of its subsidiary, Old Aetna, by an ex-

change of its own stock for that of the minority stockholders. Since stock rather than cash was the medium of exchange, this transaction *was* a reorganization. Applying the rationale adopted in *Casco Products* and thereby treating the merger element as a mere "legal technique" to effect the acquisition, the reorganization in question here should properly be viewed as an exchange of stock for stock, rather than solely as an exchange of stock for assets. Therefore, the transaction was a B reorganization and hence falls outside the scope of Section 381(b)(3).

The defendant urges this Court to reject the *Casco Products* decision. Without reiterating the merits of that decision, it should be recognized that the Tax Court, by reason of its specialized jurisdiction and experience with the tax laws, is especially well situated to cope with narrow interpretative questions of the kind presented in this case. Unless clearly erroneous, the Tax Court's construction of technical provisions such as Section 381(b)(3) should be accorded great weight by the federal courts. While the Tax Court is not the sole repository of judicial wisdom in tax matters, where the question is technical and limited in character and the Tax Court has already established a useful and consistent framework for decision, the courts of general jurisdiction should avoid the creation of conflicting precedent unless convinced that the Tax Court's interpretation is seriously erroneous.

While the ruling issued by the Internal Revenue Service on October 22, 1964 recited that the acquisition by New Aetna of the assets of Old Aetna in exchange solely for voting stock of Aetna Life would constitute a C reorganization, the Service did not rule that a B reorganization was absent, or that its C-reorganization characterization applied for purposes of Section 381(b)(3). The defendant implies that, only if the transaction qualified as a C reorganization would the benefits of Section 815(f)(3)(B) apply and the "phase III" tax imposed by Section 802(b)(3) thereby be avoided with respect to Aetna Life's distribution

of New Aetna shares to the stapled trust. However, the same result would have followed if the Service had not characterized the transaction as a C reorganization, but had determined — as it properly could have — that the acquisition by Aetna Life of the minority stock in its fire and casualty subsidiary was a B reorganization. *See* Section 815(f)(3)(B)(i).

That this transaction qualifies as a tax-free reorganization under both Sections 368(a)(1)(B) and (C) is unexceptional. Instances of overlapping definition are commonplace in the reorganization field. Where, as here, the B and the C definitions are jointly applicable, the restriction contained in Section 381(b)(3) does not apply. The defendant does not suggest otherwise. Moreover, faced with a similar question, the appellate courts have uniformly held, and the Treasury now concedes, that Section 381(b)(3) has no application to an F reorganization even though the same transaction also meets the A or the C definition or qualifies as a tax-free liquidation under Section 332. *See* cases cited at Brief for the Appellant at 24. The Treasury acquiesces. Rev. Rul. 75-561, 1975 Int. Rev. Bull. No. 52, at 20.

CONCLUSION

For the reasons stated in the Brief of the Appellant, and those stated herein, the judgment of the District Court should be reversed and remanded with directions to enter Summary Judgment in favor of the plaintiff for the relief requested.

Respectfully submitted,

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IN THE UNITED STATES COURT OF APPEALS

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CERTIFICATE OF SERVICE

It is hereby certified that service of the Reply Brief of the Plaintiff-Appellant has been made upon opposing counsel by mailing two (2) copies thereof, on this 7th day of May, 1976, in an envelope, with postage prepaid, properly addressed to him as follows:

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